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TAGS: ENRG EINV EC
SUBJECT: ECUADORIAN LAW VIOLATES CONTRACTS OF OIL COMPANIES

REF: QUITO 106 AND PREV.

Classified By: ECONOMIC COUNSELOR LARRY L. MEMMOTT, REASONS 1.4 (B,D)

¶1. (C) Summary: President Palacio's partial veto of new hydrocarbons legislation makes passage of very bad legislation inevitable. Within thirty days, and more likely within two weeks, the legislation will come into force, violating the contracts of two U.S. oil companies (and four companies from other countries). Substantial payments to the GOE will be required within weeks. Neither the President nor Congress can, at this point, resolve this issue. A constitutional challenge is likely, but will probably take months; and it may be unsuccessful given the politicization of the Constitutional Court. One U.S. company, City Oriente, has already declared force majeure in order to break contracts with its suppliers and subcontractors as it will not be able to continue its investment. Occidental is still analyzing the impact of the law, but is very pessimistic. This clear and open violation of our bilateral investment treaty calls into question the usefulness of continuing free trade negotiations with Ecuador. End Summary.

¶2. (C) After a day of intense meetings, President Palacio signed a partial veto of the hydrocarbons law on the afternoon of April 7. Although Embassy contacts ranging from the Spanish Embassy to the Deputy Minister of Commerce had expressed confidence as late as early afternoon that the President was looking to minimize the damage to bilateral relations and relations with the oil companies, sources who were there tell us that the Minister of Economy, Diego Borja, the proponent of this law, convinced the President to use his veto to restore most key provisions of the original law (which Congress had modified). It some ways the new version may even be worse. The main relief gained in the partial veto, the exemption of marginal fields, is not relevant to the U.S. companies.

¶3. (U) Following Ecuadorian constitutional procedure, the partially vetoed law has been returned to Congress. Congress has thirty calendar days in which to act. It can pass the vetoed version by a majority vote, it can pass the version it sent to the President by a two-thirds majority, or, if it fails to act, the vetoed version will enter into force at the end of the thirty days.

¶4. (U) Either law violates the contracts of the oil companies by instituting a new revenue-sharing mechanism which would force companies to share with the government all income generated by prices higher than the prices at the time the original contracts were signed. The original Congressional version of the law applied to all oil companies and applied a standard 60/40 split (in favor of the

government) of these "excess" revenues. The President's version of the law makes the state share "at least 50%" and the government has suggested that a sliding scale would be established in the regulations increasing the government's take as the price increased. As written, it appears that the revenue sharing would apply to all production by a company, even to those barrels which, by contract, the companies must turn over to the state oil company for its sale. The windfall "tax" applies to gross rather than net proceeds, allowing no credits for production costs and investments.

Implications for U.S. Companies

¶5. (SBU) Three U.S. companies operate in the Ecuadorian oil patch. Burlington Resources (recently acquired by Conoco) has two blocks, but both are in force majeure as the indigenous populations will not allow Burlington access to the blocks. Burlington also owns shares of two other blocks, which are operated by other companies. The company does stand to lose from the effect of the legislation on those blocks.

¶6. (SBU) City Oriente is a small, family owned company operating only one block on the Colombian border. Operating on a credit line of $100 million, City has increased its production from 800 bpd when it purchased the block from Encana in 2003 to 4,000 bpd today. Although City purchased the block in 2003, the contract with the GOE which it effectively purchased was negotiated in 1995, when the price of oil was about $18 per barrel. Although the purchase and investment of City was based on oil prices in 2003 (about $30 per barrel) and afterward, the legislation would require the company to share all revenue generated by prices above $18. With the threat of this legislation, City's bankers in Houston curtailed its credit last week. The company has now declared force majeure in order to terminate several contracts with suppliers and contractors that are longer sustainable. City does have one well being drilled at present, and will complete that well before ending all investment. City is currently looking into its legal options, including a possible appeal to the Constitutional Court or international arbitration under its contract or the U.S.-Ecuador Bilateral Investment Treaty.

¶7. (SBU) Occidental Petroleum's situation is the most complex, and Occidental has not completed a review of its options. It expects to complete that review by Wednesday and will inform us of its intentions. Occidental's contract was signed when oil prices were at about $13 a barrel, and the company is the largest private producer of oil in Ecuador. Oxy, therefore, clearly has the most to lose. Furthermore, this law comes on top of, and severely complicates, what were ongoing negotiations with the GOE to resolve a legal dispute which could result in expropriation of Oxy's $1 billion in Ecuadorian assets. We will provide further information on implications for Oxy and the course Oxy intends to pursue when it is available.

Available Alternatives

¶8. (C) The Charge discussed the case with the Spanish Charge on April 10. He said that Spain's Repsol, the fifth largest private producer of oil in Ecuador, is also still studying its options. Their initial analysis, like that of City, is that the only possibilities are a constitutional challenge or international arbitration under their bilateral investment treaty. Most likely, both would be pursued simultaneously. He said he expected the Spanish government would take no public position on the issue, leaving the company to fight its own fight.

¶9. (C) Our contacts suggest that a constitutional challenge would take months and they are unsure how it would turn out. For a private party to lodge a constitutional challenge, it must first gather 1,000 signatures, probably not a problem for the companies involved, but it would take time. The court process would normally last at least three months. That would mean that the earliest a decision could be issued

would likely be in September, scant weeks before presidential and congressional elections. As the Constitutional Tribunal is a political body (elected by Congress only six weeks ago), its decision would be more political than technical or legal. The court is controlled (5-4) by the Social Christian Party (PSC by its Spanish acronym), which neither actively supported nor opposed the hydrocarbons law. It is unclear that the PSC would be willing to overturn such a popular measure, even if the decision were delayed until after the elections.

¶10. (U) International arbitration is the other option most likely to be chosen by companies affected. Most arbitration provisions, however, like the one in the U.S. Bilateral Investment Treaty, require a notification period of six months before the arbitral process even begins. Smaller companies may not be able to wait for an arbitral decision which could take years.

¶11. (C) Comment: The GOE has again put short-term political and financial considerations ahead of long-term interests and rule of law. This unilateral alteration of the contractual terms of U.S. companies clearly violates our Bilateral Investment Treaty. The potential consequences of this action were clearly delivered to Ecuadorian FTA negotiators in Washington ten days ago and by the Ambassador to President Palacio last week. While we need to wait a few days to get a full analysis of the implications of this legislation for our companies and their preferred course of action, our initial take is that the USG will need to firmly uphold our principled position that FTA talks cannot resume while this law remains in effect.
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